
**A Report on the Marketing of
British Columbia Natural Gas**

Final Decisions and Comments

July 1984



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British Columbia

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A PREAMBLE

This paper summarizes the decisions made by the government of British Columbia on outstanding matters of principle regarding the restructuring of British Columbia's natural gas industry. A paper outlining a number of decisions was released in September 1983. These decisions were made after an assessment of recommendations made to the government by a Study Group, chaired by Dr. George W. Govier, in its report entitled *A Report on the Marketing of British Columbia Natural Gas* (the *Report*). The September 1983 paper, entitled *Decisions and Comments*, postponed making decisions on certain recommendations and invited interested parties to submit written comments on these recommendations to the Minister of Energy, Mines and Petroleum Resources.

The comments received have been carefully considered in making the outstanding decisions. These comments, together with changing circumstances in the natural gas industry, have also led to the modification of three decisions in the earlier *Decisions and Comments* paper. This paper is not a stand-alone document and should be read in conjunction with the *Report* and the September 1983 *Decisions and Comments* paper.

The government wishes to express its appreciation to those who have submitted comments and to those parties who have expressed their views and concerns through direct consultation. Their contributions have been of considerable assistance to the government in developing its position on the outstanding recommendations.

It is the intention of the government to expeditiously implement the marketing and royalty system as described by the decisions herein and in the September 1983 paper. It is anticipated that the natural gas marketing system can be fully restructured and the new royalty system be in place by January 1, 1985.

B REVIEW OF OBJECTIVES

The restructuring of British Columbia's natural gas industry is being undertaken in an effort to stimulate exploration, development and marketing of British Columbia natural gas. More specifically, the objectives are:

- . reduction of government participation in the marketing system to encourage more competitive and aggressive marketing;
- . higher, more predictable netbacks to producers to revitalize the industry and attract greater exploration activity;
- . reasonable prices to British Columbia consumers;
- . increased revenues to the Province;
- . decreased financial risk to the British Columbia Petroleum Corporation (BCPC).

The government recognizes that certain problems facing the British Columbia natural gas industry cannot be solved easily or immediately. Resolution of some of these problems is beyond the control of the government of British Columbia or anyone else in the Province. A prime example is the depressed United States market for natural gas.

The government does not expect the new gas marketing and royalty system to resolve all current difficulties. Rather, the new system will provide an institutional framework which will allow and encourage the British Columbia natural gas industry, particularly producers, to create and take full advantage of future opportunities. Furthermore, the new system will be sufficiently stable and predictable to improve the confidence of both gas producers and consumers while at the same time meeting the requirements of the government.

C MAJOR DECISIONS PREVIOUSLY ANNOUNCED

C.1 Institutional Decisions - In the September 1983

Decisions and Comments paper the government announced that existing rights with respect to existing contracts and existing pipeline and processing facilities will be maintained. The BCPC will also continue to represent the Province's interests with regards to Westcoast Transmission Co. Ltd.'s (Westcoast's) cost of service before the National Energy Board (NEB). While the decisions on the respective marketing roles of Westcoast, the BCPC and producers were postponed, it was decided that the BCPC will take a temporary ownership position for all natural gas to protect the Province's constitutional jurisdiction over the resource.

The government announced that producers will be permitted to sell natural gas directly to end users. To make this workable, the government will support those parties making submissions before the NEB to have Westcoast act as a contract carrier and processor.

C.2 Financial Decisions - A new wholesale pricing policy

was announced that will phase the provincial average wholesale price to a target level of 65 percent of the energy equivalent cost of crude oil at the Vancouver refinery gate by 1990. This pricing policy will help ensure competitive advantage for natural gas relative to oil which is a fundamental objective of the Province's energy policy. In addition, it will provide predictable prices for end users on which to base their investment decisions.

A new formula-based explicit royalty system was announced which will be applied to all gas produced on Crown land in the Province including gas sold to the BCPC under existing contracts. Royalty rates will be inversely related to finding and production costs, and will be directly related to the age of a well, allowing producers a more rapid payback in the early years and then a more gradual payback as the well matures. The new royalty system will allow producers to share in the risks and rewards resulting from changes in gas prices and sales volumes.

The total field price, on a unit basis, on which royalty will be calculated will be the average domestic wholesale price plus the export flowback and the appropriate natural gas liquids revenue less the Westcoast domestic cost of service, the producer cost allowance and the BCPC cost of service (e.g. administration of export flowback etc.).* The new royalty system, together with the new wholesale pricing policy, will provide higher and more predictable producer netbacks.

* All terms and procedures will be clearly defined in the *Petroleum and Natural Gas Production and Royalty Accounting Manual* (see Section D.3).

D DECISIONS PREVIOUSLY ANNOUNCED WHICH HAVE BEEN MODIFIED

D.1 Minimum Deemed Price for Direct Sales - For direct discount sales to eligible buyers (see Section E.4), other than sales to a liquefied natural gas export (LNG) project, royalty will be assessed on the actual transaction price. The government announced in the September 1983 *Decisions and Comments* paper that royalty would be calculated on the higher of a minimum deemed price or the transaction price, but the government has since concluded that the lower royalty revenue on these sales is acceptable in return for the considerable spin-off benefits anticipated through further processing of natural gas within the Province. The government does, however, reserve the right to impose a minimum deemed price on non-arm's-length transactions between sellers and eligible buyers.

On LNG export sales, royalty will be calculated on the higher of the minimum deemed price or the transaction price. The minimum deemed price on LNG export sales, announced in December 1983, will ensure that the Province will not receive a lower royalty on LNG exports than on domestic sales and traditional United States export sales of natural gas. For purposes of LNG sales, the deemed price will be equivalent to the average domestic wholesale price plus the export flowback and the appropriate natural gas liquids revenue less the Westcoast domestic cost of service, the producer cost allowance and the BCPC cost of service.

- D.2 **Export Flowback** - The export flowback will be extended to all gas production except that supplying an LNG export project. However, the export flowback on gas sold to eligible buyers at a discount price will be prorated. For example, if the selling price is discounted by 20 percent, the export flowback will be reduced an equivalent amount.

The government announced in the September 1983 *Decisions and Comments* paper that gas sold at a discount to domestic eligible buyers would not qualify for the export flowback. However, the government has concluded that this would discourage discount sales and would be inequitable to producers. Providing full export flowback for discount gas is considered inappropriate because this would in effect subsidize the discount sales, permitting the discounts to be larger than would be warranted by market forces.

- D.3 **Royalties** - The new royalty system, as announced in the September 1983 *Decisions and Comments* paper, has a sharp increase in the age factor after the twelfth year of a well's production. Hence, the royalty rate jumped similarly in that year. This may be considered inequitable for 'new' wells that began production in the first few years after the 'new' category was introduced in November 1973. The definition of age has therefore been modified so that no 'new' gas will be subjected to the higher royalty rate before January 1990. The age factor will also be defined in months, rather than in years. This will remove the inequity that would arise if a producing well was subsequently shut-in for complete months due to a lack of markets.

The new royalty system will be extended to associated gas produced from oil wells. However, since volumes are relatively low and of minor economic significance in the drilling and production of oil wells, a single value for the sum of cost-related factors will be applied province-wide. The price adjustment factor will still apply.

The royalty under the new system will be based on the total wellhead value (except sulphur) of the raw gas, expressed in dollars per thousand cubic metres. The total wellhead value (i.e. total field price) will include a cost allowance for producer-owned gathering and processing facilities.

Implementation details on all matters related to royalty calculation and collection will be published in a manual, entitled the *Petroleum and Natural Gas Production and Royalty Accounting Manual*, scheduled to be released in September. Seminars will be held to familiarize the industry with the detailed information contained in this manual.

E DECISIONS ON OUTSTANDING ISSUES

E.1 The Role of the British Columbia Petroleum Corporation -

The government accepts *Report* recommendation 21 which permits the BCPC to non-exclusively purchase future contracted gas.* Permitting the BCPC a marketing role will further increase the competitiveness of the industry and the likelihood of increased sales of British Columbia gas. The government's direct participation in the natural gas industry will be reduced over time as other parties aggressively market British Columbia gas.

A marketing role for the BCPC is supported by major domestic utilities because it provides flexibility and security of natural gas supply to provincial natural gas consumers. Moreover, it should make the BCPC more effective in representing the interests of the Province at National Energy Board (NEB) hearings on Westcoast's cost of service.

An important objective of the government is the reduction of the BCPC's current and future financial risk exposure. More specifically, the government wishes to reduce the BCPC's risk with respect to take-or-pay on the BCPC's purchase contracts and the guarantee of Westcoast's cost of service. To ensure that the BCPC will not incur significant future take-or-pay liabilities and will

* The term 'future contracted gas' refers to gas which is obtained for the purpose of providing a service for which a new or revised sales contract will be required.

recover gas already paid for but not taken, producers will be required to reduce the load factor on their contracts with the BCPC in exchange for a share of future price increases under the new marketing and royalty system. The load factor for 1984 will be adjusted to 40 percent and thereafter will be adjusted annually to a market-related level for the remaining life of each contract.

The BCPC guarantees Westcoast's cost of service for British Columbia gas through the Westcoast/BCPC Basic Agreement and the 'Hewitt letter'.* In the future, when gas is sold by third parties with Westcoast acting as contract carrier, this guarantee will involve unacceptable risk to the Province. Hence, the 'Hewitt letter' will be withdrawn as soon as practicable (i.e. after the NEB has established Westcoast's tolls and tariffs).

* The 'Hewitt letter' was sent by the then Minister of Energy, Mines and Petroleum Resources, the Honourable J. Hewitt, to the NEB on March 8, 1979 in the course of the 1978/79 Westcoast Rate Application and stated that the Province of British Columbia would "through its agent, the B.C. Petroleum Corporation, ...absorb any increase in the cost of service finally determined by the Board in these proceedings applicable to Intra-Provincial gas through the operation of the Petroleum Corporation/Westcoast contract in order to permit the Board to leave the existing tariff in the British Columbia distributor contracts unchanged".

- E.2 Westcoast's Role** - The government accepts *Report* recommendation 15 which gives Westcoast a non-exclusive right to purchase, gather, process and market future contracted gas. Westcoast has considerable marketing expertise and experience and will have the opportunity to develop innovative methods to expand sales.

The government also concurs with the *Report's* suggestion that Westcoast's marketing function should be kept separate from its utility functions. Risk associated with its marketing activities should not be reflected in its cost of service. The government will make representation to the NEB in this regard and expects that producers, who will have a direct interest in Westcoast's cost of service, will also make representations as they deem appropriate.

- E.3 Producers' Role** - As a corollary to the government's decisions on roles of Westcoast and the BCPC, the government accepts *Report* recommendations 4(a) and 10 giving producers the option of marketing future contracted gas to any buyer including Westcoast and the BCPC.

- E.4 Eligible Buyers for Direct Sales** - Producers now have the option of selling future contracted gas to the BCPC or Westcoast or any other buyer including agents. These sales will be governed by wholesale pricing policy with a few exceptions. Ammonia/urea projects, LNG export projects and U.S. pipeline exports were approved as 'eligible buyers' in the September 1983 *Decisions and Comments* paper entitling them to negotiate the transaction price with producers. In February 1984, the government expanded the 'eligible buyers' category to include all petrochemical and fertilizer plants.

For petrochemical and fertilizer plants, natural gas is the principal factor of production for the industry, accounting for the vast majority of manufacturing costs. The Province wishes to encourage the development of a petrochemical industry in British Columbia and approving petrochemical and fertilizer plants as eligible buyers will assist that objective. The industrial benefits associated with these plants are anticipated to compensate for the sale of feedstock gas at a discount price.

- E.5 Gas Marketing Committee** - The *Report* recommended that, if favoured by producers, an informal gas marketing advisory committee be established by the Ministry of Energy, Mines and Petroleum Resources (the Ministry), with representation from the BCPC, Westcoast and producers (recommendation 11).

Given the views of producers, the government will not initiate the creation of such a committee. Of course, the Ministry wishes to encourage regular consultation with the industry and is prepared to discuss issues of concern whenever they arise.

- E.6 Underground Natural Gas Storage in Lower Fraser Valley** - Downstream storage may be an efficient alternative to future expansion of the existing transmission system. With Westcoast's sales currently below transmission system capacity, the economic attractiveness of downstream storage is limited. However, as sales and peak demand increase, the benefits of downstream storage may become increasingly attractive.

The government accepts recommendation 6 and hence the Ministry will, at the appropriate time, re-post Crown petroleum and natural gas rights in the Fraser Valley in order to promote exploration drilling which could also result in the discovery of a reservoir suitable for gas storage. The government also accepts recommendation 7 that the Ministry invite requests for exploration permits from parties interested in underground storage only.

Special regulations may be required for seismic exploration and drilling in this environmentally sensitive area. Companies will be informed of these regulations when the land is posted.

SUMMARY OF DECISIONS TAKEN ON THE RECOMMENDATIONS
IN THE REPORT

<u>Recommendation</u>	<u>Decisions</u>
1	Accepted
2	Accepted
3	Accepted
4	Accepted
5	Accepted in principle
6	Accepted
7	Accepted
8	Accepted
9	Accepted
10	Accepted
11	Comment solicited, rejected
12	Accepted
13	Accepted
14	Accepted
15	Accepted
16	Accepted in principle
17	None - already effected through NEB decision
18	Accepted in principle
19	Accepted
20	Accepted
21	Accepted
22	Accepted
23	Accepted
24	Rejected
25	Accepted with modification
26	Accepted with modification
27	Accepted
28	Accepted with modification
29	Accepted in principle
30	Accepted
31	Rejected
32	Accepted with modification
33	Accepted
34	Accepted
35	Accepted
36	Accepted
37	Accepted
38	Accepted
39	Accepted
40	Accepted
41	Rejected
42	Accepted in principle
43	None - obsolete
44	None - obsolete
45	None - obsolete
46	Accepted